



April 1, 2009

Ms. Mary F. Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: ANPR for Part 704, Corporate Credit Unions

Dear Ms. Rupp:

I am filing this letter with NCUA in response to your request for comments. USA Federal Credit Union is a 56 year old federally chartered credit union serving a multi-SEG field of membership. Our primary focus has always been our nation's military. We currently have assets of \$700 million and operate 22 branches, half of which are located in Japan and Korea on military installations.

Before I provide comment on the corporate restructuring, I'd like to make a few general comments on your recent actions involving the conservatorship of U.S. Central and WesCorp. Since USA Fed is based in San Diego and we were members of WesCorp, these actions have greatly impacted our financials.

Our credit union began experiencing losses related to our mortgage and manufactured housing portfolios in mid-'07 as the subprime mortgage implosion ensued. As a result of these losses, we have cut operating expenses dramatically by outsourcing entire departments, cutting programs for our members, laying off staff (twice), discontinuing our employer match on the 401(k) plan, selling loans and running off deposits to protect net worth, as well as working diligently with members to modify their loans and keep them in their homes. It has been challenging, to say the least.

The first assessment announced in January essentially robbed us of a year's net worth cushion. The second assessment plus the write down of PIC and MCS at WesCorp robbed us of much more. Our net worth has suffered tremendously. The issue is not the necessity of the conservatorships. The issue I have was the lack of guidance to credit unions being impacted by these assessments. Proper accounting treatment, proper transparency, inconsistent messaging amongst NCUA board members. It only added to the fear and angst of the entire credit union movement.

The market will eventually correct itself – it always does. As long as liquidity exists for the corporate network and these securities remain unsold, we will survive this. But credit unions needed to understand what led to these extreme actions and needed to know how to treat the entries. By not being clear, you invited even more criticism on the agency and appeared secretive, subversive, and careless in your actions.

1. The Role of Corporates in the Credit Union System.

Corporate credit unions play an important role in the overall function of natural person credit unions by providing liquidity, payment services, and meeting short-term investment needs. All of these functions should remain in place. However, investment concentration should be closely reviewed and perhaps changed in order to protect us in the future.

2. Corporate Credit Union Structure.

We are a relatively small movement. I have felt for many years that we operate too many leagues and too many corporates for such a small movement. I also believe that the two-tiered approach for corporate has outlived its usefulness. I would envision a corporate system that closely mirrors the Federal Reserve Bank Branch approach, with roughly that same amount of branches dispersed throughout the country to serve the needs of natural person credit unions.

3. Capital of Corporate Credit Unions

Now that we know how quickly capital can be eroded at the hands of the regulator, having sufficient capital will be important. However, tier II capital or PIC, I predict, will be harder to come by in the immediate future. Credit unions have been severely harmed by the loss of MCS and PIC capital through these conservatorships. They'll think twice before ever exposing their members' money in such a way again.

4. Corporate Governance

No strong feelings about this. Outside representation would be fine, as long as the majority of the board is made up of its user/members. I have no issues with compensation for outside directors.

5. Fields of Membership

National fields of membership are fine. Competition is good for the industry as a whole, whether it be amongst natural person credit unions or corporates. For a natural person credit union to have no other choice but a local corporate creates a disadvantage in the marketplace, similarly to natural person credit union choice. If several credit unions compete for a consumer's business, the consumer always wins.

I have read and fully support the detailed recommendations for each of these areas that have been submitted by CUNA's Corporate Credit Union Task Force. These recommendations are attached and are italicized :

II. Discussion of Recommendations and Key Points

A. The Future Structure of the Corporate System

CUNA is aware that the first task the Board must deal with regarding corporate credit unions is stabilizing the system in the near-term. Once that has been accomplished, a transition to a revised system will be necessary. In our comments that follow, we deal only with what the optimal system should be, not with the mechanism of how to transform the current system to its future form.

Corporate credit unions have historically fulfilled an important role by providing natural person credit unions with settlement and payment services. In addition, corporate credit unions have played a major role in meeting both the short- and long-term investment needs of credit unions, and in providing short- and medium- term loans to credit unions.

As a result of the current economic crisis, many corporate credit unions have experienced a dramatic reduction in the market value of their investments. These reductions have been exacerbated by the virtual shutdown of the market for mortgage-backed securities and other investments. This series of events has severely undermined the stability of the corporate credit union system.

CUNA believes that the future structure of the corporate credit union system must be very different from the one that has evolved over the past three decades, if it is going to be well positioned to meet the needs of member credit unions while successfully managing risk. Changes must be made to the number of tiers within the system, the number of corporate credit unions, the services they provide, their capitalization, and governance. Ultimately, the driving factor must be the set of services that it is essential for credit unions to receive from a corporate system. Once those services are established, the remaining issues concerning the future of the corporate system can be determined.

B. Services Provided by the Restructured Corporate System

Services currently provided by corporate credit unions can be divided into the following mutually exclusive categories:

- Payment processing, such as checks, ACH, Wire Transfers, ATM and debit, etc. Payment processing involves transferring information about financial transactions (payments) so that the financial institutions of both the payor and payee know when to debit or credit whose account by how much. In addition to corporate credit unions, a number of other vendors provide various types of payment processing to credit unions.*
- Settlement. This function involves transferring money among financial institutions to settle out the net effect of inflows and outflows resulting from payments and other credit union transactions. Settlement requires a financial institution charter, and maintaining accounts at a Federal Reserve Bank and other financial institutions to execute and manage the transfer of funds.*

- *Short-term investments. This function involves investments credit unions make with overnight funds, and other short-term investments. The limit for short-term investments could be as short as three months, but no longer than one year.*
- *Short-term liquidity. This function involves providing short-term lending to credit unions. This could be for as short as overnight to facilitate a credit union's settlement accounts, to slightly longer to allow credit unions to adjust to monthly or seasonal liquidity flows.*
- *Long-term investing. This involves portfolio investing for credit unions with longer maturities than defined as short-term investing.*
- *Long-term liquidity. This involves longer term lending to credit unions. Credit unions typically undertake such borrowing not to adjust to net loan and savings inflows, but instead for asset/liability management purposes such as holding longer term loans.*

*Among these services, **the** core function that credit unions require from a corporate credit union system is settlement. Settlement provides the point of contact of the credit union movement with the rest of the financial system, and we believe that credit unions would be placed at a significant disadvantage if they had to individually arrange for settlement services with correspondent or Federal Reserve banks. Settlement is a function that can be performed efficiently at scale by just a few endpoints for the entire credit union system.*

Whatever institution provides settlement services must also be able to provide short-term investing and liquidity. A credit union's settlement account is its overnight, interest-earning account. Access to overnight or very short-term loans is also necessary for settlement. These then comprise the core functions that the future corporate system must be designed to offer: settlement, short-term investments, and short-term liquidity.

Payment processing is often linked to settlement and short-term liquidity and investment, and there can be efficiencies in a corporate credit union offering various types of payment processing. CUNA supports payment processing as a permissible activity for corporate credit unions because it is often so closely related to settlement.

C. Long-Term Investments and Concentrations in Such Investments for Corporate Credit Unions Should Be Curtailed and Managed

Many believe that, in the future, corporate credit unions should not be engaged in longer-term investing (on the corporate credit union's balance sheet). Long-term investments and liquidity are not crucial to the settlement function, and longer-term investing has been the source of most of the serious problems in the corporate system: CapCorp, and the current problem of unrealized losses on illiquid securities. Corporate credit unions could in theory successfully and safely engage in providing term investment services on their own balance sheets, but permissible investment activities would need to be more

restrictive than current regulations, and corporate credit unions would have to be required to hold capital levels far in excess of what credit unions would likely be willing to provide. A number of credit unions believe there is not enough capital in the credit union movement to fund long-term investments on the balance sheets of both natural person and corporate credit unions. Another consideration in removing long-term investing from corporate credit unions is the fact that it is feasible for credit unions to meet their long-term investing needs through means already available outside corporate credit union balance sheets: securities purchases, mutual funds, investment advisory services, and deposits in other financial institutions.

Corporate credit unions have traditionally held relatively broad authority to engage in long-term (greater than one year) investing. Absent such authority, corporate credit unions likely would not have been able to obtain the favorable yields they have been able to garner and pass on to their member credit unions. Obtaining such yields, however, has not been without substantial risk for the corporate credit union system. Furthermore, as the system is currently structured, losses stemming from these long-term investments can have a direct, detrimental affect on natural person credit unions and on other aspects of the corporate credit unions' operations, including payment and liquidity services.

Part 12 C. F. R. 704.5(c), Investments, of NCUA's Rules and Regulations, describes corporate credit unions' current basic investment activities, which CUNA supports for corporate credit unions going forward. These include investments in:

- Securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act;*
- Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and certain mutual savings banks;*
- Corporate CUSOs;*
- Marketable debt obligations of certain corporations; and*
- Domestically-issued asset-backed securities.*

Additionally, Appendix B to Part 704, Expanded Authorities and Requirements, details the riskier investments that qualifying corporate credit unions can purchase, such as long-term investments rated no lower than BBB. NCUA attempts, in Appendix B, to mitigate the risk involved with these investments by mandating that participating corporate credit unions fulfill "additional management, infrastructure, and asset and liability requirements." Corporate credit unions seeking to purchase long-term, Appendix B investments must first be granted prior approval—which can subsequently be removed at any time—by NCUA.

Even with the above-mentioned safeguards, the risk to the entire credit union system associated with certain short term investment, such as asset-backed securities, and long-term investments in Appendix B may be too great. The possible long-term investments enumerated under Appendix B include those that have resulted in much of the corporate credit unions' unrealized losses and other-than-temporarily impaired assets.

However, while removing the authority to invest in riskier long-term investments will reduce the risk to the entire credit union system, such limitations will also have the consequence of reducing the earning potential of natural person credit unions. Many of these credit unions have already been heavily invested in their corporate credit unions.

In light of these concerns about investments and concentrations of assets in a limited number of investment vehicles, CUNA encourages NCUA to consider the extent to which longer-term, riskier investments for corporate credit unions should be dramatically curtailed and whether alternative means for natural person credit unions to invest in some additional investments should be pursued.

To be clear, CUNA encourages NCUA to consider whether natural person, not corporate, credit unions should have the option to purchase alternative investments vehicles, such as those authorized under the proposed Credit Union Regulatory Improvement Act (CURIA). Section 301, Investments in Securities by FCUs, of CURIA, for example, would authorize the Board to permit natural person credit unions to purchase certain investment securities as the Board sees appropriate. Allowing natural person credit unions to make such investments through providers outside the credit union system would have the effect of moving some of the risk away from the National Credit Union Share Insurance Fund (NCUSIF). Any investment losses suffered by natural person credit unions would affect the NCUSIF only if they substantially reduced the credit unions' net worth, and even then might be covered by FDIC insurance if the investment provider were a federally insured bank.

D. The Number of Corporate Credit Unions and Their Tiers

Once the primary function of corporate credit unions has been determined to be the provision of settlement services and closely related activities, the issue of the appropriate number of corporate credit unions can be addressed. Processing payments and handing settlement are scale businesses, so the number of corporate credit unions can be sharply reduced to a very small number. With only a few, large corporate credit unions serving natural person credit unions, there would no longer be the need for a two-tiered structure.

Achieving economies of scale and enhancing the ability of the credit union system to influence and interface with the settlement process supports a good case for having only one corporate credit union. Under this approach, the remaining corporate credit union would serve as the settlement gateway from the entire credit union movement to the rest of the financial system on settlement and related issues. The principles and recommendations outlined in this letter would not preclude that outcome.

However, economies of scale are not the only considerations regarding the number of corporate credit unions into the future. Beneficial effects on pricing and innovation are also needed, which may be harder to attain without some direct credit union-market competition.

In any event, CUNA does not support having NCUA determine the appropriate number of corporate credit unions. Rather, we believe that as a result of capital requirements and limits on services and

investments, member credit union owners should contemplate no more than a very limited number of corporate credit unions – small enough to take advantage of economies of scale, but large enough to foster innovation and competition.

E. Corporate Credit Union Capital

CUNA believes that a corporate credit union's minimum Tier 1 capital ratio should be at least 4 percent and possibly higher, up to 6 percent over a reasonable period of time. If NCUA chooses to institute risk-based capital requirements for corporate credit unions, such risk-based capital should be comparable to those applicable to similarly situated FDIC-insured depository institutions. CUNA believes that market factors, such as corporate credit unions' payments system counterparties' concerns about counterparty risk, will generally encourage corporate credit unions to maintain higher net worth ratios of up to 6 percent.

CUNA believes, however, that risk-based capital requirements are likely unnecessary for corporate credit unions if NCUA adopts CUNA's recommendations for limitations on corporate credit unions' business and investment activities, as outlined above. CUNA believes that if NCUA has concerns regarding the amount of capital necessary to cover corporate credit unions' payment and settlement risks, it should consider requiring a payment and settlement risk reserve that would be deducted from Tier 1 capital but included in Tier 2 capital to some degree, as discussed below under "d."

1. Components of Corporate Credit Union Capital and Capital Ratios

CUNA believes that a corporate credit union's regulatory capital should consist of Tier 1 capital—reserves and undivided earnings (RUDE) as well as paid-in capital (PIC)—and Tier 2 capital. Corporate credit union Tier 2 capital should include member capital shares (MCS) as well as subordinated term debt and general reserves such as the "Reserve for Payment and Settlement Risk" discussed below.

CUNA also believes that Tier 2 capital for corporate credit unions could include subordinated term debt because U.S. low-income credit unions count subordinated debt—in the form of a "secondary capital account"—as regulatory capital, because Canadian credit unions count subordinated debt as regulatory capital, and because U.S. federal banking regulators and the Basel Committee on Banking Supervision also consider subordinated debt to be Tier 2 capital.^{[\[4\]](#)}

2. Require PIC Investments for Access to Corporate Services and Lengthen MCS

CUNA believes that natural-person credit unions should make meaningful PIC investments in a corporate in order to use that corporate credit union's services, that the callable period of member capital shares (MCS) should be extended to five years from three years, and that corporate credit unions should be permitted to write down called MCS over five years rather than two.

In general, a natural person credit union's required PIC investment in a corporate credit union should be calculated based on the investing credit union's asset size, and its required MCS balance should be based upon its usage of the corporate credit union's services.

Requiring natural person credit unions to contribute perpetual or 20-year-callable PIC to their corporate and extending the callability and write-down periods for MCS will strengthen the corporate credit unions' capital positions. In addition, required PIC subscriptions by a corporate credit union's natural person credit unions members would give all users of a corporate credit union's services an increased incentive to monitor their corporate's management and business activities.

CUNA also believes that NCUA should consider making natural person credit unions' PIC investments transferable from one corporate to another, so long as the PIC of state-chartered corporate credit unions would not be considered "capital stock" within the meaning of 26 U.S.C. § 501(c)(14)(A). CUNA believes that transferable PIC would not likely qualify as "capital stock" so long as it is clearly designated as a form of deposit.

3. Risk-Based Capital

If NCUA restricts corporate credit union business and investment in the manner suggested by CUNA, above, risk-based capital requirements for the corporate credit unions would likely not be necessary. However, if such investments are not restricted, then risk-based capital for corporate credit unions engaging in those activities is essential.

Under the Basel II risk-based capital rules developed by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the FDIC,^[5] a corporate credit union that is invested solely in U.S. Treasury securities and other highly-rated fixed-income investments^[6] would have an 8 percent risk-based capital ratio requirement that would generally be lower than the amount of capital required by a 4 percent net worth ratio.

Stated another way, risk-based capital requirements for corporate credit unions would generally be irrelevant—if corporate credit unions were subject to a minimum 4 percent net worth ratio and a minimum 8 percent risk-based capital ratio—until a corporate made significant investments in assets in the Basel II 50 percent risk category or the 100 percent or 150 percent risk-weight categories. Most potential corporate credit union investments would be placed in the 50 percent (or a higher) risk-weight category if they are rated below AA-.

4. Reserves for Payment and Settlement Risk

CUNA believes that corporate credit unions should hold sufficient capital to be insulated from operational risk arising from payment and settlement activities, possibly including a capital charge deducted from Tier 1 capital to establish appropriate reserves for payment and settlement risk.

Under the Basel II standardized approach to controlling for payment and settlement operational risk, a corporate credit union's payments and settlement risk capital charge would be 18 percent of the three-year average of the corporate credit union's annual gross income from payment and settlement activities.

CUNA believes that this reserve for payment and settlement risk should be deducted from Tier 1 capital but should be included in Tier 2 capital (possibly subject to a percentage of assets limitation, such as 1% of assets) because, under Basel II rules, this reserve would qualify as Tier 2 capital. This reserve qualifies under Basel II as Tier 2 capital because it is a general reserve that does not reflect a known loss or deterioration in a particular asset, and would be available to meet unidentified losses that may subsequently arise.

F. Corporate Credit Union Governance

CUNA believes that the boards of directors of corporate credit unions should generally consist of representatives of their member natural person credit unions, but that a corporate credit union should have the option of having up to 20 percent of its board consist of non-member directors if its members so choose.

CUNA wishes to note that most current corporate credit union directors are "outside directors" or "independent directors" within the common definitions of those terms, since they are not officers of the corporate credit union and, as individuals, have no direct financial interest in the corporate.^[7] These directors are typically representatives of the corporate credit unions' member natural person credit unions, none of which are individually able to exert control over a corporate because credit unions' one-member-one-vote voting structure prevents the concentration of voting power in the hands of a few. CUNA believes, therefore, that comparisons between the governance of corporate credit unions and that of for-profit, stock corporations with significant numbers of "inside directors"—i.e. those who are also officers of the corporation and/or who represent the interests of controlling stockholders—are inapt.

Outside directors "are considered important because they are presumed to bring unbiased opinions to major corporate decisions and also can contribute diverse experience to the decision-making process."^[8] CUNA believes that the outside directors representing the interests of corporate credit unions' member natural person credit unions currently serving on corporate credit unions' boards already bring unbiased opinions to major corporate decisions. CUNA does not believe that corporate credit unions should be required to have outside, non-member directors because most current corporate directors already qualify as "outside directors" and because non-members may have interests that do not align with those of the corporate, or with the interests of credit unions generally.

CUNA believes, however, that corporate credit unions should be permitted the option to have non-member directors who can contribute diverse experience to a corporate credit union's board, if the corporate credit union's member natural person credit unions so choose. A corporate should be permitted to have up to 20 percent of its board be composed of non-members and also be permitted to

offer a non-member director a reasonable director's fee comparable to that paid by federally-insured depository institutions of similar asset size, so long as the amount of this fee and any other director compensation is disclosed to the corporate credit union's members. The NCUA Board has authority under section 120(a) of the Federal Credit Union Act to authorize a corporate to have non-member outside directors and to pay those non-member directors a reasonable fee.

G. National Fields of Membership

CUNA believes that the small number of corporate credit unions that operate in the future should continue to have national fields of membership. Without overlapping fields of membership, there would be no competition among corporate credit unions, and therefore no need to have more than one. CUNA understands that competition among corporate credit unions may have in the past contributed to thinly capitalized institutions, operating on very low margins, taking significant investment risks. However, with sufficient capital requirements (below) and with investments restricted to only those necessary to perform short-term investing and liquidity for credit unions, CUNA believes that competition among corporate credit unions would provide for better service to credit unions in a context of full safety and soundness

Thank you for the opportunity to weigh in on these important issues facing our movement. It is my sincere hope that you will, from this point on, make every effort to provide greater transparency and to be more cognizant of the impact your actions make on natural person credit unions and their 90 million members.

Sincerely,

A handwritten signature in black ink that reads "Mary Cunningham". The script is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Mary Cunningham
President/CEO
USA Federal Credit Union
9999 Willow Creek Road
San Diego, CA 92131

Phone: 858-831-8184